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RUEHZL/EUROPEAN POLITICAL COLLECTIVE

UNCLAS SECTION 01 OF 02 BELGRADE 000489

USDOC FOR 4232/ITA/MAC/EUR/OEERIS/SSAVICH

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: ECON EINV ETRD EFIN SR
SUBJECT: Serbia: First Quarter 2009 Results - Crisis Continues,
Government Optimistic

BELGRADE 00000489 001.2 OF 002

Summary

¶1. (SBU) Serbia's first quarter 2009 macroeconomic figures show further economic deterioration. However, with his usual economic optimism Deputy Prime Minister Dinkic claimed that Serbia had passed the low point of the crisis and would see "better and better news." Positive signs included the stock exchange indices, which climbed in April and May while the number of blocked accounts of companies held steady. With an estimated first quarter GDP growth rate of minus 5.2% National Bank Governor Jelasic said that Serbia had avoided the worst of the crisis, but the question remained when there would be light at the end of tunnel. Fiscal revenues were down by 16% from the same time last year and the budget gap has widened beyond what was agreed with the IMF, making another budget rebalance almost certain. End Summary.

Production Down, Prices Up, Dinkic Optimistic

¶2. (SBU) Serbia's industrial production decreased by 16.9% in the first quarter (Q1) of 2009 year on year (y/y). Production further fell in April to 21.1% y/y, but Stojan Stamenkovic of the Economic Institute said that the fall was caused by warm weather in April (reducing electricity production), and a temporary halt in oil derivatives production; and thus the actual drop was 17%. The largest decline was in the production of basic metals, chemicals, motor vehicles, and furniture. However, eternally optimistic Deputy Prime Minister and Economy Minister Dinkic said on May 13 that the results started to improve in March- the drop of industrial production in March was 14% y/y - and that Serbia reached the bottom of the crisis in February. National Bank Governor Radovan Jelasic said on May 25 that Serbia avoided the worst of the crisis. Bosko Zivkovic, Economic Faculty banking expert stated on June 2 that the crisis was slowly easing.

Blocked Accounts Number Steady, Stock Indices on Rise
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¶3. (SBU) A positive signal, according to Economic Analysis and Research Director at the National Bank of Serbia (NBS) Branko Hinic on May 28, was that the number of companies whose accounts were blocked due to illiquidity has been steady since the beginning of May, unlike the previous months when it was constantly increasing. In line with the official optimism, the Belgrade Stock Exchange Belex15 index, which had been declining for almost a year, started to recover in April and May, climbing back to its January 2009 level.

GDP Growth Rate of Minus 5.2% in Q1

¶4. (SBU) According to the NBS's May 2009 inflation report, Serbia's GDP growth was minus 5.2% in the Q1 2009 y/y mostly due to the drop in industrial production (17%) but also due to a drop in trade (14%). First quarter retail turnover also decreased by 15.4% y/y. The drop in retail demand, as Hinic explained, came from hesitation about borrowing (in December 2008 real annual growth rate of consumer loans was 11.8% while in March it was only 3.3%). NBS analysts also expected that unemployment would grow in the near future since companies would be less interested in hiring.

Foreign Trade Shrank By Over a Third

¶5. (SBU) Serbia's foreign trade continued to shrink in early 2009 with the global crisis, a decrease in the prices of basic commodities which are the bulk of Serbian exports, and the drop in industrial production. Exports in January-April 2009 shrank by 35% y/y to $2.27 billion whil%:Qp\Qyrimary trade partners remain Bosnia-Herzegovina as the top export destination for Serbian goods followed by Germany and Italy. Russia is the number one source of imports. Despite the crisis, Serbia maintained a trade surplus with CEFTA countries mostly thanks to strong exports of agriculture products.

Everything Sinking But Inflation

¶6. (SBU) Unlike in other countries, where the drop in production and/or demand has cut inflation, retail prices in Serbia in May were up 10.4% y/y and 8.7% since the beginning of 2009. Nearly two-thirds of the increase resulted from increases in government controlled prices. However, the NBS expects inflation to slow down and has targeted 8.8% inflation for 2009. Hinic noted that NBS cut the main interest rate slightly from 16.5% in January to 14% in May, but said that it was likely the rate would decrease in the near future. On June 8 NBS made an additional small cut in the rate from 14% to 13%.

Banks: Liquidity Questions

¶7. (SBU) Hinic complained that the decrease in the main interest rate did not transfer into lowering banks' lending rates. Overall bank loans at the end of Q1 were only 1.1% higher than at the end of 2008, a significant slowdown in credit growth. At the same time, in the first four months 2009 net cross border borrowing was negative - companies returned $188 million to foreign banks, exactly what NBS tried and hoped to stop via the voluntary agreement in Vienna with international banks. Net FDI in Q1 reached $836 million, mostly due to revenue from the sale of oil firm NIS to Gazprom for $520 million.

¶8. (SBU) The foregn exchange market returned to stability in March. The Serbian dinar nominally depreciated against the Euro by 9.6% in Q1. The NBS has not intervened in the market since February ¶26. Hard currency reserves went down from $13 billion at the end of 2008 to $11.5 billion end of April 2009. Citizens slowly regained trust in the banking sector and increased savings in banks by $124 million in Q1 to reach $6.37 billion at the end of March.

MFIN Headache: Q1 Fiscal Revenues Down by 16% y/y
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¶9. (SBU) As a result of the fall in production and GDP, budget revenues in Q1 fell by $171 million y/y or by 16% in real terms; thus becoming a real headache for the government. Tax revenues were

down by $110 million or by 14% in real terms, with the biggest drop recorded in VAT collection (-13%), customs (-30%), corporate profit tax (-25%), income tax (-5%), and excise tax (-6%). Non-tax revenues were down by 40%. Compared to the 2009 budget revenue projection the first four months revenues were nominally 13% below the 2009 projection. On the other hand current budget expenditures recorded a 14.5% nominal increase and reached $2.21 billion in Q1 ¶2009. The bulk of the increase resulted from an increase in pension transfers, and capital expenditures. Compared to 2009 projections expenditures through April were nominally 9.5% below projected expenditures. The government deficit was $163 million for Q1 2009, with total revenues of $2.13 billion and total expenditures of $2.29 billion. Recognizing the difficulties, Finance Minister Dijana Dragutinovic said on May 29 that the government might ask the IMF in August to allow the budget deficit cap to widen to 4% of GDP from the current 3% under the Stand-By Arrangement.

COMMENT

¶10. (SBU) Serbia managed to survive the first quarter without significant damage to the financial system. The 2008 IMF Precautionary Program and the follow-on $4 billion Stand-By Arrangement which was approved in May have helped stabilize and reassure markets. However, once summer is over there will likely be renewed macroeconomic pressure on the government. Government measures that subsidized interest for bank loans increased liquidity, but have not stopped the continuing fall in production as orders dry up. The government continues to struggle with its own debts to suppliers, and has asked for Parliament approval to guarantee commercial bank loans to settle half of the $440 million debt owed by Serbia's state road company. The pressure is still on the government to come up with a plan to deal with the continued economic slow down this fall.

BRUSH